SPEECH

McDonough: Accepting the Distinguished Achievement Award for 1999

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Remarks by President William J. McDonough before the Money Marketeers of New York University

Good evening. I am delighted to accept this very special award from the Money Marketeers of New York University, and Henry, I thank you for your most generous remarks. In accepting the Distinguished Achievement Award for 1999, I know that I follow a group of most outstanding former recipients, among whom I am happy to count such notable economists as you, Henry, as well as a number of my FOMC colleagues, Alan Greenspan, and last year's honoree, Alice Rivlin, whose presence on the FOMC I will sorely miss. I am also pleased to note that this group has also chosen to honor a number of my predecessors at the New York Fed, including Paul Volcker, Tony Solomon, and Jerry Corrigan, in addition to a number of former senior New York Fed officials--Peter Sternlight, Sam Cross, and Bob Roosa. I am truly honored to be this year's recipient of your award.

I never had the privilege of meeting Marcus Nadler, the founding spirit of the Money Marketeers of New York University and a long-time student of the financial marketplace. Having attended functions of the club over the years and having heard others speak of him, however, I believe that he was someone who was convinced that logic and common sense took you a long way in understanding financial markets and institutions. The jargon that is often used today and the higher mathematics that is often applied to describe the workings of the economy and the financial markets certainly have their place. But at the core of the thinking of any policymaker, academic, or practitioner, there must be some fairly basic concepts. This, at least, is how I try to approach issues. As I have often remarked, if the CEO of a financial firm cannot explain an operation to his or her Board of Directors in clear language, the firm should not be in that line of business.

In my remarks to you this evening, I would like to focus on the importance of a sound banking and financial system to the health of a country's economy. In addition, I would like to highlight some of the concerns I have about loan quality in the United States today.

Before turning to these issues, let me touch briefly on the unique growth record we in the United States have been enjoying for close to a decade. In looking over the economy, it is hard not to be gratified by the remarkable performance of this very long expansion. Unemployment remains remarkably low, productivity growth continues to be high by the standards of the last generation, and signs of inflationary pressures have until just recently been negligible.

In this environment, there has been a good deal of talk--some of it learned, some of it highly speculative--about whether the U.S. economy has entered a "new era." Frankly, I don't see how one knows when one is in a new era or not. Clearly, as public servants, we want people to enjoy the benefits of strong growth and low unemployment. We have been pleasantly surprised by real growth being higher than we expected and inflation lower than we anticipated. As a resident of New York City--and someone who cares deeply about the health of this nation's cities--I am especially pleased that in recent years the U.S. economic expansion has begun to reach the inner cities of our country.

Today, I am happy to note, we in the United States have the lowest unemployment rate in three decades. And the portion of our adult population that wants to work, that is, the participation in the labor force, is the highest we've ever had--including the years during the Second World War. This is truly a remarkable economic achievement. Why, we may well ask, has the United States had such an extraordinarily strong economic performance when so few other countries have been doing particularly well and many have been doing quite badly?

One conclusion I've drawn is that the public sector--which generally is most helpful when it gets out of the way of the private sector--has been doing an unusually good job in recent years. After thirty years of fiscal imprudence, we have a federal budget in the United States that not only is in considerable surplus but also is likely to remain there. Today, one of the main arguments between our two major political parties is which one is the more fiscally prudent. No one could have imagined this outcome ten years ago.

In the case of monetary policy--the other major tool of government policy--I conclude, with some modesty aside--that the policy pursued by the Federal Reserve has been just about right. This policy has permitted the U.S. economy to function better than any economic model would have said was possible as recently as five years ago.

Many economists have argued that if the unemployment rate were to fall below some critical level, then workers would demand higher wages. These demands, in turn, would lead to higher prices and, potentially, inflation, causing the Fed to step in.

Well, we've had an unemployment rate below 6 percent for years now and it's been below 5 percent for the last two years. Yet inflation has not been rising. In fact, by most statistical measures, over the past few years, inflation has been falling. Of course, one has to be wary about monthly consumer price index figures. Recent monthly data have been unusually volatile and they defy simple analysis. It is a time to be vigilant.

What accounts for this strong real growth and benign inflation performance over the past several years? I believe that a large part of the answer lies in the extraordinary job the private sector--unleashed by good public policy--has been doing in improving productivity--the output per hour of labor. Credit for this improvement in productivity performance must go to American businesses, which began to turn around in the mid-1980s. At that time, most American manufacturing companies were not at all competitive internationally and basically were facing one of two choices: either fold or restructure. Not surprisingly, they chose to restructure and, to do so, they needed good bankers to take the risks with them--to finance those restructurings and help them get on with their jobs.

I believe it is important to recognize that American labor, both organized and individuals, cooperated significantly in this massive restructuring of our economy. In part, workers contributed to low wage pressures, as they become more directly involved with the profitability of their firms through a proliferation of performance bonuses, profit sharing and stock options. The result has been that productivity, which was dismal from 1973 into the 1990s--growing less than 1 percent a year--began to pick up around mid-decade. In recent quarters, productivity has been growing at an annual rate approaching 3 percent.

I wish I could point to some pat explanation for the recent improvement in U.S. productivity performance, but I'm afraid there is little agreement on this issue. There are those who think that the tremendous investment in information and communications technology is behind the recent improvement, and this is probably a partial answer. But I believe that the improvement in productivity performance is accompanied by recognition on the part of American businesses that raising prices is not the path to success. This is because, in most cases, businesses simply can't get away with doing so. We've seen this happen time and time again.

When an industry tries to raise its prices and finds it cannot do so, as recently happened in the airline industry, other business leaders realize that the only way they can keep their profit margins intact in a tight labor market without being able to raise prices is to improve productivity. So improving productivity has become critical, and the key question has become which American business person is more imaginative than the next? The answer to this question may be closely related to how good the bankers are behind that American business person.

When I think about these issues, I tend to look at them along the lines Schumpeter suggested years ago. Namely, given the way a market economy works, there is a fundamental need for one basic institution--a bank. Why? Because there are people who like to save and others who would like to start a business--and it is the banks that are the link between the two. If the bankers do their jobs well, the economy is likely to flourish.

But what does it mean for a banker to do a job well? In my view, it means knowing how to make a good loan and how to avoid the temptation to make a bad loan. This doesn't mean that bad loans can't be made from time to time--that's part of the learning experience. What one doesn't want is for the bad loans to mount excessively.

The importance of the banking industry and the fact that, in my view, banking systems are not strong in many countries have a lot to do with why the rest of the world is not performing as well economically as we in the United States. If you look for a common characteristic among the Asian countries that have faced difficult economic problems in recent years, you will find that in all of them there were serious weaknesses in their banking systems.

When these Asian economies experienced periods of rapid economic growth and began to run out of sensible things in which to invest, they turned to high-rise office buildings that failed to get rented--and they did this on a larger scale than we in the United States did in the mid-1980s. When their economies started to falter, no strong banking system was there to absorb part of the shock. This left only the real economy to absorb the shock, which, of course, affected peoples'- lives very quickly, especially the lives of the poor.

One of the difficulties many of the Asian countries continue to face is that so few bankers in these countries have any experience in working out a problem loan. This lack of experience stems in large part from the fact that the bankers in these countries have also had insufficient experience in making credit decisions based solely on financial criteria. In many countries in the region, loans were made because the Ministry of Finance thought that the company receiving the loan was in a business the government wanted to encourage. In other cases, bank loans were made because the borrower was either related to or a friend of a person in a powerful position.

Clearly, these are not conditions that can lead to a sound banking system. Training people whose judgment management will respect in risking the loanable funds of the bank takes time. And in countries where there are no traditions of sound banking practices, banking systems need to be built largely with outside help.

Some people might conclude that under these circumstances all that is really needed is to put together a group of good bank supervisors. I would argue, however, that you can have the best bank supervisors in the world, but they can't do much good unless they have the help of good bankers. Bank supervisors have never made a loan--unless they used to be bankers--and they are not trained in how to collect loans. That is the job of a banker.

What's essential in some of these countries, then, is to figure out ways to build banking systems that are based on sound credit decisions. Good bank supervisory practices will then follow or can be developed simultaneously.

The most important country in Asia, Japan, is very much an example of what I am talking about. Many Japanese banks have had to be rescued by capital infusions from their government. Yet, still, the country suffers from a very severe credit crunch, of a kind we haven't had in the United States for a while but with which we are all familiar. That is, borrowers have been too worried to risk taking on new debt and the bankers have been loath to make new loans. And so, little happens. The result in Japan has been a recession, one that only just recently has shown signs of reversing. Put another way, the second most important national economy in the world, behind our own, still has much work to do.

In Europe, growth for most countries moves along at a very slow rate, with Germany and Italy barely growing or just beginning to grow and France growing at maybe 2 to 2 1/2 percent. Ireland, I am pleased to note, has reversed years of slow growth and has been registering rapid growth--a Celtic tiger!

Banking systems in much of Latin America also need strengthening. Mexico is doing rather well, and its banking system should benefit from the opening up of the country to foreign banks. Brazil, which was so troubling only months ago, seems to be doing better, largely because, in relative terms in emerging market countries, it has one of the strongest banking systems. Argentina, which has been going through a fairly difficult recession, also possesses a rather good banking system, one in which foreign banks are heavily invested. What happens when foreign influence is significant is that the foreign banks set a new standard for banking in the country. The result is that all the banks in the country improve, not just the banks in which foreigners invest.

Where are we going from here? I am hopeful that recent signs of improvement in Europe and Japan will take hold and that this will help the emerging market countries turn around.

In the meantime, I continue to be optimistic about the U.S. economy. I believe we will continue to have good, sound fiscal policy, and I think you can count on the Federal Reserve to pursue a monetary policy that permits sustainable economic growth.

What we must be careful to remember is that the way the Federal Reserve keeps growth sustainable is through price stability, which we define as a sufficiently low level of inflation that people don't take inflation into consideration when they make investment or personal consumption decisions. I think we have that now.

But let's be clear. We can maintain price stability only if the Fed keeps alert to two things. First, the Fed does not want the economy to go into a recession or deflation. But there's very little danger of that. At this point, the issue is the potential for inflation, which, if allowed to break out, is destructive to the economy.

When the Fed says it wants to sustain economic growth, this does not mean growth for the sake of growth at any cost, including that of inflation. Growth is what the Fed wants, but it has to be growth that is driven by productivity increases and good business leadership and helped by a strong banking system.

Let's look at what the Fed has done over this long economic expansion. One can easily argue that the doubling of the official interest rate, the Fed Funds rate, from 3 to 6 percent from 1994 to 1995 had at least as much to do--if not more--with the continuation of the economic expansion as the easing of policy has had since then.

What we have to keep in mind is that there is no monetary policy, in any country, that always has lower interest rates any more than there is a monetary policy that always has higher interest rates. The way the Fed has to behave is to continue to support the very fine performance of the U.S. economy by doing what is required to maintain price stability. This is what will help to keep the economy growing.

One of my major concerns going forward has to do with the quality of bank lending. Most important, it seems to me, is to bear in mind that bankers often make the worst loans when things look best. And because things look awfully good at the moment, I cannot help but remind bankers and supervisors alike that the sun doesn't always shine, that the rain sometimes falls--even in places you don't want it to--and that the business cycle is not dead. In a positive economic environment, such as in the United States right now, it is critical that bankers make certain that their loans look fully collectible when they are made. This is a difficult prescription, especially for younger bankers who don't really know what a recession--certainly a serious recession--looks like.

Banks are now at a crucial phase of the credit cycle. After many consecutive quarters of high profits, low delinquency rates, and comfortable capital ratios, it is easy to forget the lessons of past credit downturns. The most significant of these lessons is the importance of maintaining rigorous credit standards, especially in an environment of increased competition for new and existing customers.

In this regard, I note that the Fed's most recent quarterly poll of senior loan officers indicates that banks have maintained and may have actually tightened credit standards in recent months. This finding suggests that there has not been a significant deterioration in lending standards thus far in the credit cycle. The tightening of standards appears to have been broad based: both large and smaller banks in the Senior Loan Officers Opinion Survey in May reported tightening standards for both large and small borrowers.

But the recent robust performance of the banking industry should not lull bankers or their supervisors into a false sense of complacency about the need for sound risk management practices and the importance of market discipline in ensuring the future health and efficiency of the banking system and, indeed, of global capital markets. Some of the key issues that will require the undiluted attention of bankers and supervisors alike include the following:

- Robust risk management practices over the credit cycle: Financial institutions must have the discipline to consistently apply risk management techniques through all phases of the business cycle. A concern for supervisors is the tendency of credit markets to steadily bid down spreads in the optimistic phase of the cycle, often to the point where returns are no longer commensurate with risk. Then, as problems emerge, lenders in credit markets pull back, causing spreads to reverse sharply. We saw this happen in an extreme fashion last summer.
- Credit standards: Targeting returns commensurate with risk over an appropriately long time horizon is probably the single most important defense against violent swings in the credit cycle. Individual banks can protect themselves if they recognize when margins become too thin to cover risk by restraining their credit activities at those rates. To limit credit cycle volatility, appropriate risk and return analysis must be practiced widely and consistently throughout the financial cycle.
- Stress testing: More attention must be directed at stress testing, the leading technique in assessing the direct and indirect effects of unusual market and economic events. Stress testing is fundamentally a qualitative and judgmental process, typically used in conjunction with more formal statistical approaches to risk measurement, such as risk modeling. The primary goal of stress testing is to identify scenarios--usually low-probability, high-stress events--that could jeopardize the health of a financial institution.
- Improved disclosure: There is almost certainly a need for improved disclosure. The transparency derived from more open disclosure of risk management practices, risk profiles, and risk management performance cannot help but facilitate market discipline. Timely disclosure of such information would enable market participants to better assess how much risk other market participants are taking, how well they manage it, and how much capital and liquidity they need to survive adverse markets.

In particular, the availability of more detailed data on international exposures would enhance the ability of both supervisors and counterparties to assess the vulnerability of domestic banks and banking systems to financial shocks from abroad. Better information about the credit risk profiles of large, internationally active banks would also be useful. Some of these goals for enhanced bank transparency are discussed in a report issued by the Basel Committee on Banking Supervision in September 1998.

All the issues I have pointed to are applicable not just to banks and bank supervisors but to the entire investment community as well--individuals, funds, and financial institutions. The bottom line is that all participants in the financial marketplace must know what they are doing. If an investment opportunity looks too good to be true, if everybody else is going into a country or a product but analysis suggests the gains aren't there or the risks are too high, the investment should not be undertaken. Moreover, loans should not go to those unwilling to say what they are doing or to those who answer questions in complex jargon. I can assure you that, as financial supervisors, our consciousness on these issues has been raised.

In closing, I want to thank you once again for the honor you have given me this evening and Henry, for your always thoughtful remarks. In the Money Marketeers' directory, there is a listing of "Old Doc Nadler's Remedies" for economic woes. One of these remedies says:

You're right if you bet that men in business, labor and government are sane, reasonably well informed and essentially decent people who can be counted on to find common ground among all their conflicting interests and work out a compromise solution to the big issues that confront them. While I would not confine that remark to men, I believe that Marcus Nadler had it right. There is no question in my mind that a commitment to work together toward the common goal of a sound and well-functioning banking and financial system is the best avenue toward ensuring that future generations will enjoy a prosperous and productive U.S. economy.

Thank you.